RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Jan. 11, DJIA 1218.09; PTI 1607; A-D Ratio -19.51
Jan. 18, DJIA 1227.36; PTI 1627; A-D Ratio -18.32

THE MARKET: The advisory business is a tough one. The turnover rate for letter writers attests to that. If you can last five years in the advisory business, you're doing a lot better than average. If you can go fifteen years in the advisory business, you've got a strong constitution and a superior level of talent and intuition (and probably – luck). Go twenty years and you become a Wall Street institution (I read just about all the services that have been around since the mid-1960's). And if you go over twenty-five years as I have, you probably should have your head examined – you're beyond hope.

With it all, I've discovered a few things about this business and the people in it. When you start out as an advisor you want to be a genius, you want to call every turn, you want to be the shining light of Wall Street. I tried that, of course. It never worked, because I (like everyone else), would make horrible mistakes. Then I found out there was an alternative. The alternative is simply to be honest. By that I mean that you have to realize that you can't do the impossible, that you will make mistakes and you will make wrong calls. And when you do, you better damn well let your subscribers in on it (they'll know anyway). And, oh yes, when you don't know what's going on you better say that too (subscribers always recognize fakers).

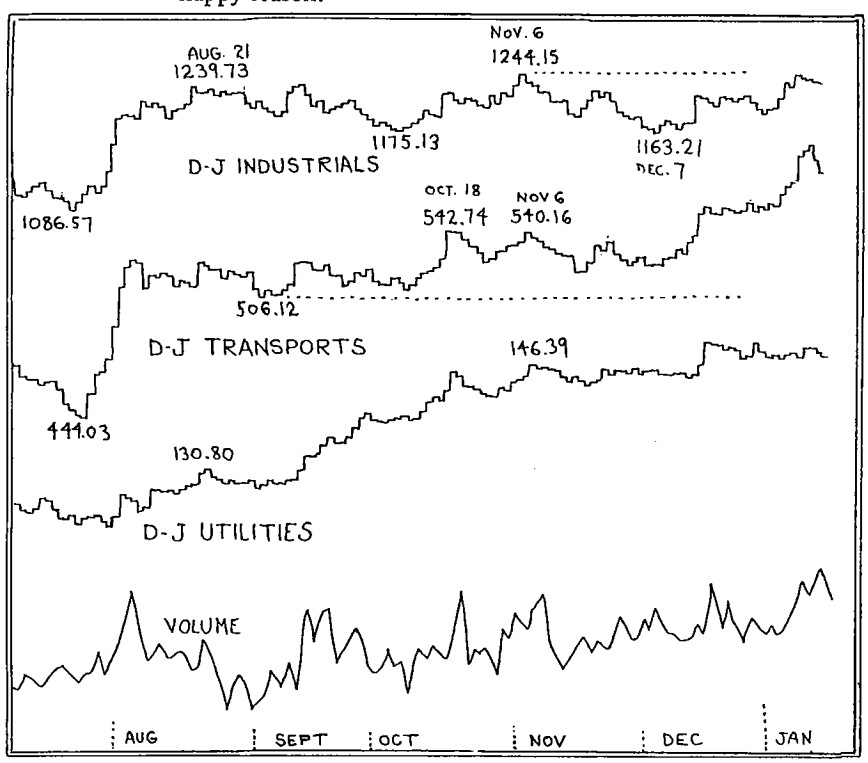
I've been writing in Letter after Letter that this market had formed a "line" in the Averages. A line appears when the forces of accumulation and distribution are very evenly matched. No matter what you hear, no matter what the experts tell you, it's impossible to forecast in advance which way the Averages (and the general market) will break out of a line formation. In time all lines are broken one way or the other, and the direction is set when BOTH Averages (Industrials and Transports) finally break out above or below the line limits.

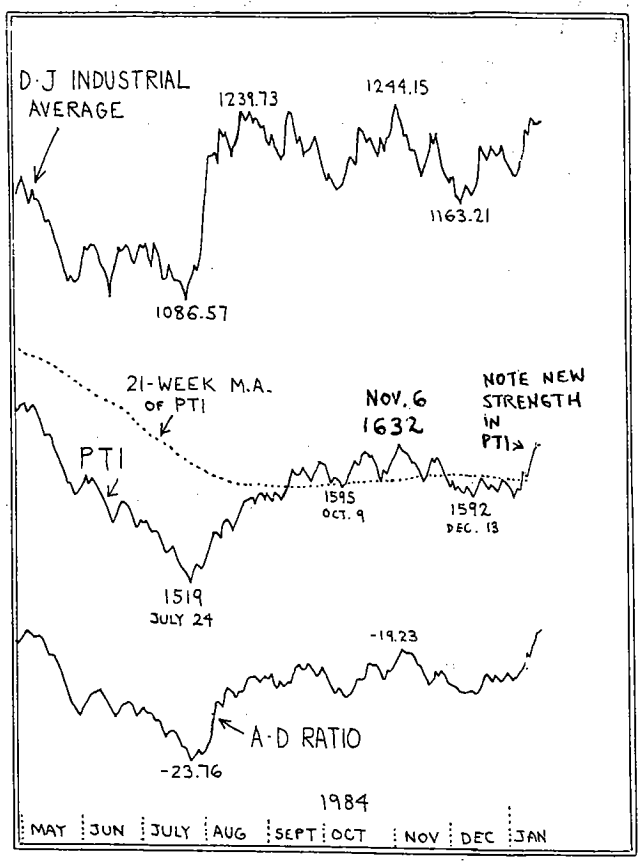
If one Average breaks out alone, such action simply extends the limits of the line formation, and that is what has been happening ever since September. We have had unconfirmed downside breaks, we have had unconfirmed upside breakouts. But in each instance we saw an immediate reversal, and the Averages would simply sink back into the line pattern . That was the story for the last quarter of 1984.

The market action since January 9 has been impressive. On January 15 the S & P 500 broke out of its own formation on the upside, advancing to its highest level since its October record high of 172.65. On the same day the NYSE Composite Index closed at 98.59, highest close since the October 10 record high of 99.63. On the face of it, it seemed only a matter of time before the Dow confirmed on the upside. There's no question about it, breadth has looked very good since January 9. Since that day we have seen daily advances on the NYSE of 1066 on Jan. 9, 1283 on Jan. 10, 903 on Jan. 11, 1312 on Jan. 14, 1021 on Jan. 15 and 1084 on Jan. 16. The Transports during that period exploded, closing Jan 16 at a new recovery high (see page 1 chart) of 595.22. But despite all this positive action, the D-J Industrial Average closed January 16 at 1230.68, still 14 points below its November 6 peak.

To add to the excitement, the advance-decline ratio (see page 2 chart) for the NYSE broke out on January 13 above its November 7 high, and this was action that pleased market technicians. My own Primary Trend Index has now pushed well above its 21-week moving average, and by January 16 it had reached 1629, only 3 points below its November 7 peak of 1632. Thus the PTI is positive in that it has reversed its downtrend, but has still not broken out above its sideways pattern of the last five months.

Turning once more to the Industrial Average, I want to emphasize again that I never dismiss a non-confirmation on the part of the Dow (although there are times when I would like to). Those thirty Dow Industrial stocks are studied, charted, scrutinized and analyzed more minutely than any thirty equities in the world. And it's critically important whether their average price now can better their Average price of November 6 at 1244.15. If the Industrials do confirm, great; things will look quite bullish. If Industrials fail, well, there must be a reason, and it's usually not a happy reason.





Question: Russell, what do you make of the huge volume since January 9?

Answer: Big volume on the upside during a period when everything (i.e., the Averages, breadth, high-lows) are in gear is fine; it's usually very bullish. But big volume before and during a non-confirmation in the Averages always worries me. It can be an indication of distribution, particularly if that big volume is accompanied by great optimism and widespread predictions of "better things to come."

Question: Russell, what would it take to turn you really bullish at this point?

Answer: Simple, I would like the D-J Industrial Averages to confirm the Transports by bettering 1244.15. And I would like to see my PTI break out above its trading range to a new high above the November 7 peak of 1632.

Question: With all the huge upside volume since January 9, why do you personally think the Industrial Average has refused to confirm?

Answer: I could give you fifty different guesses from a possible downturn in business to a possible collapse of the dollar to a possible "do nothing" by Congress on the federal budget. Or maybe all will be well, and the Industrials will better that 1244.15 level – next week or next month. But why try to outguess Dow's barometer? We don't try to out-guess the weather barometer, so why play oracle with Wall Street? Let's let the market tell its own story – in its own good time.

Question: Russell, what do you make of the big move in the D-J Transports?

Answer: I think it is due to the sharply lower fuel (oil) prices, and to the deregulation of the air transport industry. But one item nobody is noticing has to do with values, and on this basis the Transportation Average is very vulnerable. The average yield on the D-J Transports is now a miniscule 2.47%, well below the critical 3% level. Charles Dow warned that when the average stock yields sink below 3%, stocks are *overvalued,* and this observation has been born out with remarkable consistency over the years. Thus, the Transports are now in the danger zone based on average yields and regardless of their future profit potential.

Question: Comment on the daily highs and lows on the NYSE.

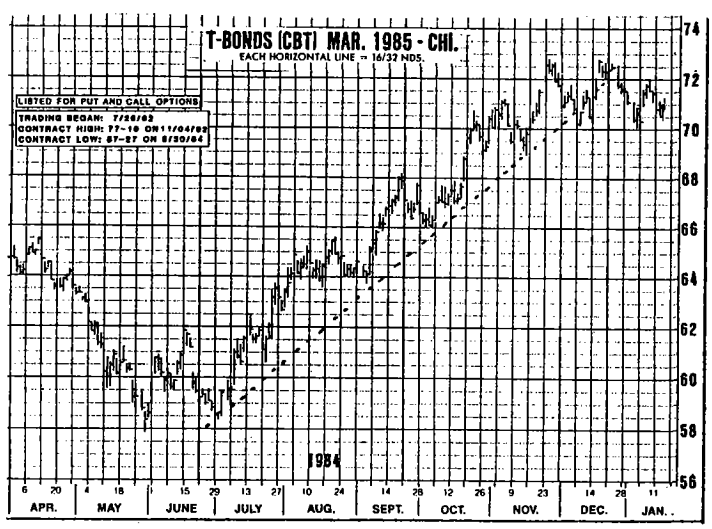
Answer: This has been one of the areas of greatest improvement, and on one method that I have used for years, the high-low ratio has at the very least produced a buy signal. By January 17 my five-day running average of new highs and new lows produced a 138 (highs) to 10 (lows) ratio, best seen in many months. The dearth of new lows is always a good indication that selling pressure has dried up.

INVESTMENT POSITION: This is a tough call. The breadth action has definitely improved, and the PTI is above its moving average again. Thus I label myself as "neutral-positive" and I keep my eyes glued on the 1244.15 level for the Dow. Look at the markets this way: (1) Stocks look pretty good here, but the Dow still hasn't confirmed on the upside yet, (2) Bonds look toppy but the March T-bond contract still hasn't closed at 70 yet (at 70 or below the bonds finally turn bearish), (3) Gold has held stubbornly above the critical 295 level, but so far no big gold rally (although some kind of a rally would seem to be overdue), (4) Commodities are still in the doghouse, but they too are overdue for a rally.

I don't think that any of the markets have yet made up their mind about what's in store for the economy in 1985. These are the times that see traders whipsawed to death. Personally, I'm not going to do anything new until the smoke clears. But I will sit with all my current positions. "Don't do something, just stand there."

BONDS, RATES: The short rates are under 8% now, but the very long rates hold above 11%. This CRB chart of the March T-bond contract shows a toppy-looking bond structure, but a structure that refuses to close at my danger level figure of 70 or below. So we hold 'em as long as that 70 is respected.

In the meantime, the munis have somewhat caught up to the Treasuries with many general obligation bonds dropping almost a



percentage point in yield since December. On a real return basis, I still think the munis are very attractive, but as stated before, I like the general obligation bonds rather than revenues (a bridge or hospital can go broke, but hopefully not the state of California or the city of Dallas).

Question: How do you like the muni bond funds vs. buying the actual muni bonds?

Answer: The funds have a few advantages. They are diversified. And you can buy them in small amounts (a tiny odd-lot in the actual muni bonds is $5,000). But I also have a couple of objections to the funds. If they charge a load to buy, that's my first objection (although not all do charge a load). Second, when you buy the actual bonds, you know you will get back par ($1,000) at maturity. But the funds have no maturity, they are managed. If a given fund does a rotten job, you can lose a big chunk of your money. In other words, unlike the actual bonds the funds cannot guarantee your money back. The unit trusts avoid that problem, but most of the units have a load charge, and I prefer to avoid the load. A load means I'm locked in with a loss for the first couple of years.

INVESTMENT PHILOSOPHY: One reason why many investors can't make money (translation: they lose money) is that they have no clear idea of what they are trying to do. They have not developed an investment philosophy. Take, for instance, the case of Charlie. A broker tells Charlie to buy Logovision and he buys it. A neighbor tips Charlie to buy into the company where he works, X-jet. Charlie buys it. Next a close friend tells Charlie that he personally has been buying muni bonds like crazy. Charlie buys munis. A year later Charlie has lost half his capital. He puts what's left into a real estate partnership. You know the rest.

Unlike Charlie, I have an investment philosophy, and consciously or unconsciously it always affects my writing. My philosophy goes like this: (1) I want a return on my money. I place the concept of a safe and reasonable return on my money above all else. Maybe I should have been a banker, but that's the way I feel. I've worked hard for my money, and I consider my money (savings) as a "second business.' I want that second business to throw off profits.

(2) At times, conditions seem right for a return on my money plus appreciation. Those times occur when a given investment appears very CHEAP. That investment item may be a stock, the whole stock market, bonds, gold stocks, you name it. A good example was Treasury bonds last spring. At yields of around 13% I thought they looked cheap, and when bonds appeared to have bottomed out I told subscribers to buy them. I told subscribers that T-notes and T-bonds looked like the cheapest and safest investment around. In retrospect, they were.

(3) As every reader of these Letters knows, I encourage COMPOUNDING your money whenever you can. Compounding is the road to riches, and it is by far the *safest* and *surest* road. Sure, you can buy 10,000 shares of XY Growth company at $1 a share and maybe you'll be rich by 1990, but the odds on picking a winner for 1990 are slim. But compound top-grade muni bonds over a ten year period and it's almost guaranteed that you'll end up with considerably more than you started with.

(4) One rule in my system is that above all I must avoid taking major losses. I don't feel any pressure to be invested at all times, I don't feel any pressure to trade, I don't feel any pressure to own stocks, bonds, gold, T-bills or anything else. But I do feel pressure to avoid losses.

"Great, Russell," you retort. "And how the devil do we insure against taking losses?"

Good question. The BEST way to insure against taking losses is to do what Charles Dow recommended, and that is to buy great values when nobody wants them. Example: December 1974. The market had collapsed, good stocks were selling at panic, give-away prices. I felt that the stocks were either a great buy or the country was not going to survive. Either way, one might just as well spend his money. I published long lists of stocks to buy. It was super-bargain time,and great blue chip stocks were selling at yields of 10% and better. In retrospect, late-1974 was a time of great values – during a period when nobody wanted to hold equities.

Warren Buffet started his operations in Omaha, Nebraska with a modicum of money. Buffet now is worth about half a billion dollars through his 50% ownership in Berkshire Hathaway stock. Buffet is widely recognized as an investment genius. I certainly think he is, and I've followed his career for years.

Buffet loves the stock market. Why? Because Buffet knows values, and he knows that at certain times (like 1974) panic overtakes the stock market. At such times stocks of companies Buffet likes go tumbling down into super-bargain areas. When those favored stocks drop way below value, Buffet buys them. Then he waits, five or ten years or more. The list of stocks Buffet has bought and the prices he paid for them is a wonder. But you and I could have done the same thing – if we had the brains.

(5) I have a lot of patience. I've trained myself to have patience (and I am not by nature a patient fellow). If you're a trader you need a lot of courage and a very strong stomach. If you're an investor you need a plan, a long-term view and patience.

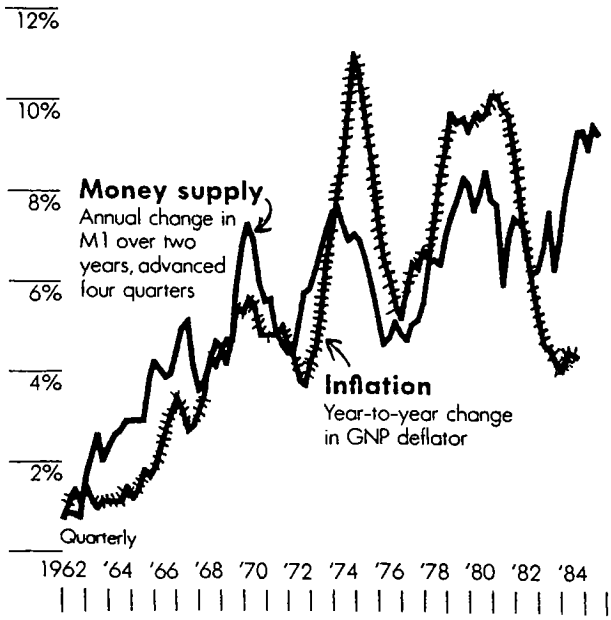
"All very good," you say, "Your philosophical dissertations are fine, Russell, but what do we do now? Translate all this golden philosophy into something I can use now."

All right, here's what I'm thinking. The markets are stuck in neutral gear right now. I'm cautious about the stock market right now. I had the bear's head (not his whole body) in Letter 902, but I've turned "neutral-bullish" since then with no animals, bull or bear, appearing in the box. I hold bonds in my own account (although I still have my kids in blue chip stocks plus bonds). And at this point, I don't feel pressure to do something – one way or the other.

Let me get this point over again. As long as I am receiving a RETURN on my money I don't feel as though I have to do anything else. If the entire year 1985 goes by, and stocks never do a thing but go sideways (or down) that won't bother me. I don't have to own any particular item at any given time. What I don't want to do is lose my capital, and if the stock market is stuck in neutral, I'm just as happy collecting bond interest (which at the moment is still better than double the average yield on the Dow). But I'll keep an open mind, of that you can be sure.

BONDS, OIL, GOLD, RATES: Why do I include all these items in this heading? Because they are all linked together. In previous years, interpreting the various trends in these four items was comparatively simple. For instance, when the price of oil was going up, this was basically a very inflationary phenomenon. When gold was rising with oil, the forces of inflation were even clearer. As inflation heats up, the Fed tends to lean against the wind, and higher interest rates are to result. As interest rates shoot skyward, bonds collapse.

Let's look at the situation today. Gold has been in a bear market since late-1980. That lends a deflationary background to the whole economic situation. But it was not until late 1984 that the professionals (and to some extent the public) perceived deflation as a possibility. But real high interest rates and the towering strength of the dollar made foreign goods a bargain in relation to the dollar. The US devoured foreign goods, and this prevented *price* inflation in the US.



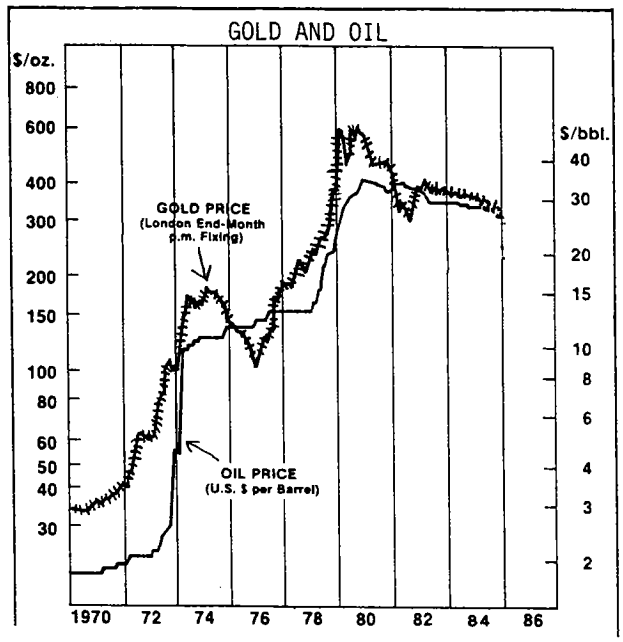
I included this chart in the last Letter, but I consider it *so important* and *so timely* that I am reprinting it again here. Note how the rate of inflation tends to follow the annual change in the M-1 money supply (even though there is a definite lag time). The important thing is that if this chart has any validity (and I believe it has) we are now moving into a critical area. What is that area? We are moving into the area where the money supply should start exerting UPWARD pressure on inflation.

But there is one unknown, one crack, in the inflationary scenario. That crack is the shaky price of oil. Cut back as they may, no amount of cut-backs seems to stem the flood of oil that is sweeping over the world. OPEC appears almost helpless to hold the price. Saudi Arabia, which produced 10 million barrels of oil a day at its peak production, has now cut its production to 3 million barrels a day – and still the world glut continues.

I am indebted to *International Moneyline* (25 Broad St., NYC 10004) for this revealing chart of the gold/oil relationship. As you can see, there is a clear bond between the price of gold and the price of oil. Both items have been in a bear market since 1980, but we could be near a pause or even an important turn. I'm not going to attempt to guess whether we are near oil/gold heaven again. I'm simply calling subscribers attention to this very important relationship.

Mr. Volcker obviously is aware of the preceding charts, and if he is, he also knows that the forces of inflation are probably not dead – no, they are just resting. And this is undoubtedly the reason why Volcker has been a bit careful about easing credit too much.

There are a number of very interesting items to watch now. If, and I say IF, we are on the edge of a (1) revival in business, and (2) a revival in inflation, then we may expect to see a number



of phenomena. First, we can expect to see gold hold at or near the 300 level – and then rally as the forces of inflation heat up. I'm not saying gold is going into a new bull market phase, but I am saying that gold could move on the upside (along with silver).

Next, if we are seeing a heating up of business and inflation then I would expect the Dow to break out of its line limits on the upside (above 1244.15), thereby confirming the new highs in the Transportation Average.

Third, if business revives, the market comes to life on the upside and inflation starts to intensify, we can expect to see the bonds break down and interest rates head higher.

The January 14 issue of Forbes contains an unusually interesting article by columnist Ashby Bladen. Bladen notes that the Fed is now trying to push the dollar down, but not by buying gold as Roosevelt did during the '30s but "by buying T-bills in order to depress short-term interest rates" . Here are a few paragraphs from the Bladen piece:

> That is what the Fed is doing and will doubtless do more of, but there will be some unhappy consequences. Inflation will worsen automatically, and long-term interest rates are much more likely to go up than down. This will happen because long-term interest rates tend to follow the inflation rate; the higher the latter, the higher the former.
>
> Foreigners have been happy to lend Americans the funds to buy their exports, at the cheap prices that kept our inflation low, precisely because they were earning high interest rates on those loans. When they no longer feel adequately rewarded, the dollar will come down with an inflation-jarring crash.
>
> Don't let the current strength in the bond market mislead you. Forty years of worsening inflation, rising interest rates and falling bond prices have converted the American bond market from an investment market to a speculative one. It is no longer a place where people put their savings to work permanently, but one where people bet on falling inflation and interest rates. This being so, another upsurge of inflation will almost certainly touch off yet another collapse of bond prices. I predict a new low in long-term bond prices in 1985—lower than those of 1981. ■

Conclusion: the two charts accompanying this section are of critical importance at this time. If inflation is indeed firing up again we can expect commodities to bottom out and head higher, we can expect stocks (probably) to head up, at least for a while. We can expect gold and silver to push higher, and we can expect bonds to top out and money rates in general to rise.

What about the dollar? That's a tough one. Rising interest rates would render the dollar more attractive, but rising inflation in the US would render the dollar less attractive. Somewhere ahead the dollar is going to top out – but where? That may be the toughest question of all.

NOTES & QUOTES : Socialism, African style: Here it is (from the Jan. 7 Washington Post Weekly).

Washington Post Foreign Service

HARARE, Zimbabwe—A Cabinet minister recently was asked by a foreign visitor at a dinner party here why, in a country publicly committed to socialist equality, so many top government officials owned Mercedes-Benzes.

"It's very simple," the minister replied. "In Zimbabwe, socialism means what's mine is mine, but what's yours we share."

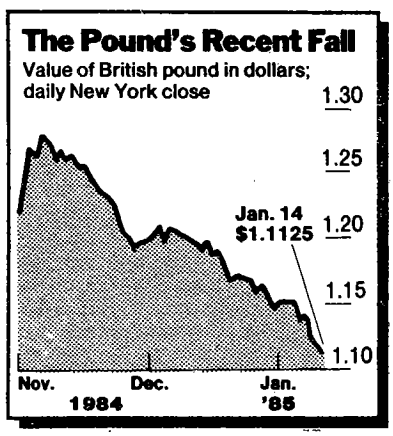
* *

Sweden is fast becoming the "do nothing" nation of the Western World under its socialist government. Sweden has broken below 30 hours for the average work week, they have a (are you ready for this?) mandatory five-week vacation, a nine-month maternity leave (which fathers can share). Swedes work an average of 28.8 hours a week, lowest in the industrialized world. And the rate of savings, well, you can just imagine. This squib was from the January 7 Wall Street Journal:

> A big reason why shorter working hours are more popular with Swedes than other Europeans is Sweden's dramatically high income tax rate, which claims an average of 60% of everybody's salary. "It just isn't worthwhile to work longer hours for cash," says Ulf Jakobsson, chief economist for the main employers' federation. "The unions are going for increased leisure instead of money, because the money is going to get taken away in tax."

* *

Five major foreign exchanges hit new highs last week. What's happening? Unemployment is very high in Europe, thereby holding wages down. But the weak currencies (against the dollar) are booming exports and corporate profits. So Europeans are running out of their weak currencies and into their rising stock markets. Ultimately, the boom in European stocks will be overdone, the capital flow to the US will reverse and the dollar will head down.



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US consumers went on a super-buying binge in 1984, increasing their installment credit by $98 billion, against increases of $60 billion in '83 and $27 billion in '82. Stores are wondering if "resting time" is due.

* *

Choking on paper work and high costs, might GM is fashioning a way to get out from under. It is starting over again! A whole new company will be formed and the name will be Saturn. The reason? One fact, it takes 200 hours to make a GM car, 100 hours to make a Japanese car. Reading between the lines, it seems to me that GM executives are saying, "GM is stuffed with so much dead wood and problems and strictures that it would be easier to start a new, efficient company than to change GM." First target for Saturn: a single factory which will produce 500 cars per year. That's the start?!

* *

The US government is growing fearful of the sheer number of lawsuits against it. By the end of 1985, there will be roughly 54,000 suits against the US totaling an unbelievable $140 billion. Planners are now afraid this wild litigation process could interfere with the budget.

* *

I've always felt that two items militate towards equal treatment of the races: (1) the law. When the law states that all men are equal, bigots have a problem. (2) Business. When business suffers lost profits from racial prejudice, the pressure is on. And number 2 is now happening in S. Africa. Last week, three major business groups signed a statement that says that changes in S. Africa's racial laws must come – and fast. But the shocker was that one of the three groups was Afrikaanse Handelsinstitute representing the interest of the conservative Dutch-descended Afrikaners.

* *

Good bye .45: After years of debate, the US military has said goodbye to the faithful Colt .45 pistol and ordered $50 million worth of 9mm Berettas, a great auto pistol which holds 15 cartridges vs. the 7 of the Colt. Beretta's auto, which retails for $500 was sold to the US for the super-special price of $179. Who says the Pentagon always pays double?!

I like both pistols, but one (Colt) has great striking power, the other has the firepower. During WW II as a bombardier with the 12th Air Force, I carried the standard .45 in combat plus a .32 Beretta automatic in my belt . We were told that the Germans would execute bombardiers on sight, and I figured that if downed I'd go out like a hero. At any rate, the Colt (in active service for 74 years) is still a great favorite with gunnies and marksmen from Maine to California, but the 9mm fits in with NATO sidearms (Europe has always preferred 9mm).

* *

It's no secret. Ronald Reagan, with a 49-state election mandate, has turned either lazy or wimpy. He's not leading the nation on the deficit/budget problem. In fact, he's been so recalcitrant that Presidential hopeful Robert Dole has now assumed leadership on budget cutting. Budget watchers (such as Richard Russell) are amazed at the lack of leadership shown by Reagan here during the "honeymoon" period of his second reign. The bond market is growing wary, and Wall Streeters are asking, "If not Reagan, who? If not now, when?"

* *

Veteran readers know that I am not enamored of trading, speculating, buying options or trading commodity futures. I guess I am just a bore, because I have three main objectives in writing these reports: (1) teaching subscribers something about the markets and the economy, (2) teaching subscribers how to avoid

losses, (3) teaching subscribers how (hopefully) to end each year with more money than they started with.

Along the lines of avoiding losses, Futures magazine asked 25 leading advisors for their choices as the "Best Trades of 1984." The consensus best choices were: go long currencies, metals, stock indexes, meats and grains. Of the five lead choices, four were down at the end of the year and the fifth (stock options) was up or down, depending on what item you picked. Expert advice anyone?

LATE NOTES: The S&P 500 closed the week ending January 18 at its highest Friday close on record – 171.32. The secondary stocks are now clearly outperforming the blue chips. Furthermore, the INFLATION-oriented stocks are now showing signs of accumulation and in many cases they are acting better than the defensive stocks. If inflation is in the wings again, we can expect (1) commodities to start up, (2) gold to start moving higher, which it may be doing now, (3) cyclical and inflation-oriented stocks to act better than the market and (4) bonds to top out.

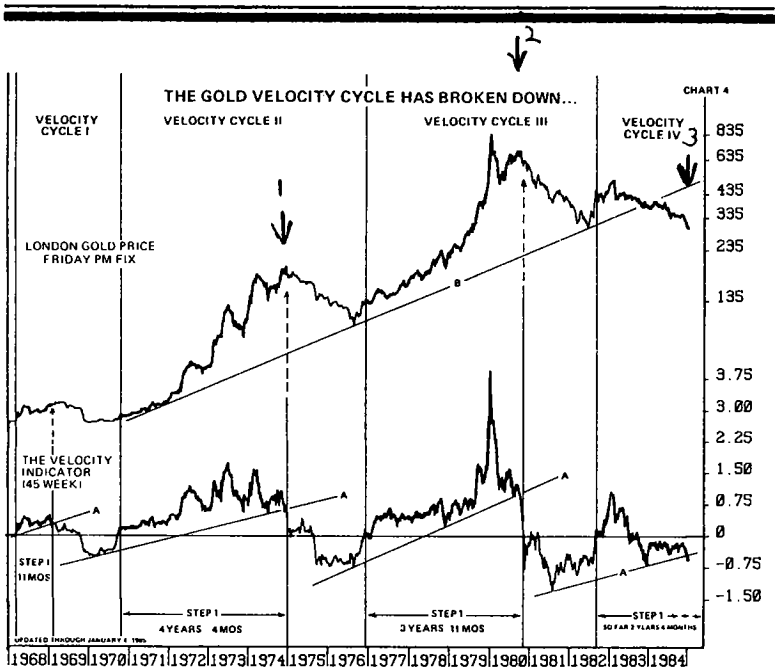
In an important speech before the National Press Club last week Henry Kaufman noted that total debt in the US has climbed from $2.4 trillion in 1974 to $7.2 trillion today. Kaufman contends that this huge credit explosion has limited the performance of the equity markets, and I agree. What this debt monster means is that the US would face horrendous trouble if a recession hit. The cost of floating this huge mass of debt is so high that only continued inflation can keep us "solvent" . In view of this (a few years ago) I coined the expression, "inflate or die" . And that's where we are today. I see it, Kaufman sees it, and the Fed sees it. Study the chart on page 4 of this Letter. And prepare for another shot at inflation, an erratic stock market and volatile commodity and bond markets. The bitter fact is that the US cannot live without inflation. Even a decline in the rate of inflation (as in 1984) sends the US economy to the edge.

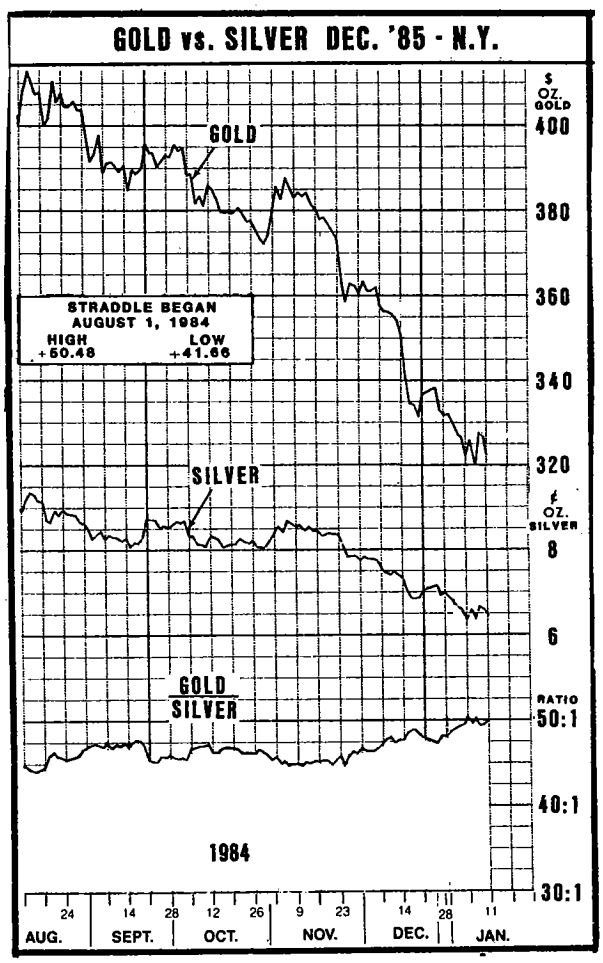
Comment, according to St. Louis Fed figures, in the two months ending 12/31/84 the money stock or M-1 grew at a rate of 10%. Who says the Fed isn't pumping?!

GOLD: Over the near term, gold could have a rally here (as long as the spot metal respects the critical 295 support level). But on the bigger picture, things don't look that good. The Aden sisters have now conceded that gold is in trouble. In their latest report 4425 W. Napoleon Ave. Metairie, LA 70001) the ladies state: "The gold price is holding at the 1982 lows and it is the only indicator left that has not confirmed a major reversal. For this reason, if gold were to have a decisive close below 290, it would also confirm that a major reversal is underway."

The Adens do fine research and they are old friends of mine, but I have disagreed with their bullish conclusions these last four years. Here is an important chart from their January report. The chart shows gold from 1968 to the present along with a 45-week rate of change line. Note that where the trendlines ("A") broke at my arrows 1 and 2, the price soon plunged. Now the third "A" trendline for velocity (rate-of-change) has broken down – arrow 3. But this time, the broken velocity comes with gold BELOW its major rising trendline ("B"). Thus, on a strict technical reading, gold looks weaker (because it is now below the major rising trendline) than it did at point 1 and 2. This seems hard to believe, but "mine is not to reason why ... " .

A second chart from Commodity Research Bureau interests me. Here we see gold and silver (Dec. '85 contracts) and the straddle (buy gold and sell silver). A year ago all the smart boys were saying the silver looked "cheaper than gold" . But the ratio (straddle) has now moved up to a whopping 50 to 1 (gold at 50 times the price of silver). Historically, that's a very fat ratio for gold over silver. But it's worth remembering that in 1932, gold was 20.66 and silver was down below 32 cents. Put that ratio on your calculator. In the end, we have to face the fact that gold is money and silver is a semi-precious metal and also an industrial metal. Gold's biggest use is in jewelry. Silver's biggest use is in photography.





NEXT MAILING: Feb. 6